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Supreme Court, U.S.
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In The

SUPREME COURT OF THE UNITED STATES
October Term, 1994

REGIONS BANK OF LOUISIANA, SUCCESSOR IN INTEREST OF SECOR BANK, FEDERAL SAVINGS BANK, joined in by BERNICE ELIZABETH HAAS and THOMAS MILTON HAAS,
Petitioners,

v.

UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE,
Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS FOR REVIEW

I.

Whether, under Section 6323(h)(1) of the Internal Revenue Code, Title 26, a federal tax lien is accorded the status of "any hypothetical judgment lien creditor," making actual notice or knowledge held by the IRS, irrelevant, for purposes of determining priority under the Federal Tax Lien Act of 1966.

II.

Whether a federal court must apply an equitable standard of reliance when the "local law" of the relevant state mandates application of such a standard.

III.

Whether Treasury Regulation §301.6323(h)-1(a)(2) prohibits "relation back" of a reinstated mortgage to the orginal date of recording.

PARTIES TO PROCEEDING

Bernice Elizabeth Haas; Thomas Milton Haas; Internal Revenue Service; United States Small Business Administration; Regions Bank of Louisiana, Successor in Interest of Secor Bank, Federal Savings Bank.

PARENT COMPANIES OF PETITIONER

12/31/93 Secor Bank, FSB acquired by Regions Corporation, a Delaware Corporation, and a wholly owned subsidiary of Regions Financial Corporation, a Delaware Corporation.

12/01/94 Secor converted from federally chartered stock savings bank organized under the laws of the United States to a newly formed state chartered banking corporation organized under the laws of the State of Louisiana, and changed its name to Regions Bank of Louisiana.

12/01/94 First American Bank & Trust Company of Louisiana, a Louisiana banking corporation and Guaranty Bank and Trust Company a Louisiana banking corporation, were merged into Regions Bank of Louisiana.

TABLE OF CONTENTS

	Page
Questions for Review	i
Parties to Proceeding	ii
Parent Companies of Petitioner ...	ii
Table of Contents	iii
Table of Authorities	iv
Reference to the Reports of Opinions	1
Grounds for Jurisdiction	2
Statutes and Regulations	2
Statement of the Case	3
Argument	6
Conclusion	28

TABLE OF AUTHORITIES

Page

Allied Group Mortg. Corp. v. Dewing, 498 N.W.2d 196 (N.D. App. 1993) 11

Aquilino v. United States, 363 U.S. 509 (1960) 8

Bank of Heflin v. Miles, 621 F.2d 108 (11th Cir. 1980) 14

BFP v. Resolution Trust Corp., ___U.S. ___, 114 S.Ct. 1757 (1994) 16,17

Baldwin Co. Fed. Sav. v. Central Bank, 585 So.2d 1279 (Ala. 1991) . 18

Bay Minette Production Association v. Citizens Bank, 551 So.2d 1046 (Ala. 1989) 27

Cameron State Bank v. Sloan, 559 S.W.2d 564 (Mo. App. 1977) . 11

Carco Acceptance Corp. v. Kunze, 69-2 USTC 85,636 (D. Neb. 1969). 12

Citizens State Bank v. United States, 932 F.2d 490 (6th Cir. 1991) 11,16

Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) 14

Connecticut Nat. Bank v. Chapman, 216 A.2d 814 (Conn. 1966) 11

Department of Revenue v. Price-Williams, 545 So.2d 7 (Ala.

1989) 18

Dragstrem v. Obermeyer, 549 F.2d 20 (7th Cir. 1977) 6,10,21

Gordon v. Gorman, 436 So.2d 851 (Ala. 1983) 11,12

In re Veasey, 43 B.R. 396 (Bankr. Pa. 1984) 21,23,26

Manalis Finance Co. v. United States, 611 F.2d 1270 (9th Cir. 1980) 20,23,25

Metropolitan National Bank v. United States, 901 F.2d 1297 (5th Cir. 1990) 21

Republic Nat. Bank of Miami v. Manzini & Associates, P.A., 612 So.2d 709 (Fla. App. 3 Dist. 1993) 11

Smith v. Arrow Transp. Co.,Inc., 571 So.2d 103 (Ala. 1990) ... 18,27

Strong v. Powell, 192 So.2d 258 (Miss. 1966) 11

Taylor v. Jones, 194 So.2d 80 (Ala. 1967) 11

United States v. 168.8 Acres of Land, Etc., 35 F. Supp. 724 (M.D.N.C. 1940) 11,12

United States v. Ed Lusk Const. Co., Inc., 504 F.2d 328 (10th Cir. 1974) 21

United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979) .... passim

United States v. New Britian, 344 U.S. 81 (1954) 9,28

United States v. Rodgers, 461 U.S. 677 (1983) 8

United States v. Thirty-Seven Photographs, 402 U.S. 363 (1971) . 14

United States v. Trigg, 465 F. 2d 1264 (8th Cir. 1972), cert. denied, 410 U.S. 909 (1973) 21

United States by and through IRS v. McDermott, ___ U.S. ___, 113 S.Ct. 1526 (1993) ..... passim

White v. White, 350 So.2d 326 (Ala. 1977) 27

Statutes

26 U.S.C. §6323(a) 2,9
26 U.S.C. §6323(h)(i) ..... passim
Ala. Code 1975 §35-4-90(a).... passim

Regulations

Code of Federal Regulations §301.6323(h)-1 26 C.F.R. (a)(2) (1994)..... 25-28

Miscellaneous

56 C.J.S. Mortgages §282(2).... 11-12

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For The Eleventh Circuit

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REFERENCE TO THE REPORTS OF OPINIONS

The opinion of the United States Court of Appeals for the Eleventh Circuit is reported at 31 F.3d 1081 (11th Cir. 1994) and is reprinted in Appendix A. The unpublished Order denying the Petition for Rehearing filed on November 3, 1994 is reprinted in Appendix B.

GROUNDS FOR JURISDICTION

(i) The opinion of the Eleventh Circuit reported at 31 F.3d 1081, filed on September 13, 1994.

(ii) The unpublished Order denying the Petition for Rehearing was filed on November 3, 1994. An extension of time in which to file the Petition for Writ of Certiorari was granted on January 17, 1995, (Justice Anthony Kennedy), extending the filing deadline to March 23, 1995.

(iii) Not applicable.

(iv) The jurisdiction of the Supreme Court of the United States is invoked pursuant to 28 U.S.C. §1254(1).

STATUTES

26 U.S.C §6323(a)

(a) The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

26 U.S.C. §6323(h)(1)

(h) For the purposes of this section ...

(1) The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or

performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

§35-4-90(a), Code of Alabama (1975)

(a) All conveyances of real property, deeds, mortgages, deeds of trust or instruments in the nature of mortgages to secure any debts are inoperative and void as to purchasers for a valuable consideration, mortgagees and judgment creditors without notice, unless the same have been recorded before the accrual of the right of such purchasers, mortgagees or judgment creditors.

REGULATIONS

Treasury Regulation 26 C.F.R. §301.6323(h)- 1 (1994) (See Appendix C)

STATEMENT OF THE CASE

This case involves a lien priority dispute between certain federal tax liens of the United States of America, Internal Revenue Service ("IRS"), and the mortgage of Regions Bank of Louisiana, successor in interest of Secor Bank, Federal Savings

Bank ("Secor"), on the homestead of Thomas M. and Bernice E. Haas ("Haas"). The jurisdiction of the United States Bankruptcy Court for the Southern District of Alabama was founded on 28 U.S.C. §157(b). The jurisdiction of the United States Southern District Court of Alabama was founded upon 28 U.S.C. §158(a). The jurisdiction of the United States Court of Appeals for the Eleventh Circuit was invoked pursuant to 28 U.S.C. §§158(d) & 1291.

On January 4, 1979, Haas executed a mortgage on their homestead in favor of a predecessor of Secor, as security for a loan in the amount of $140,994.57. From these mortgage loan proceeds, the IRS received the sum of $94,947.21 and executed a Certificate of Subordination of Federal Tax Lien in express deference to the Secor mortgage, both such instruments being recorded in the indices of the Probate Court of Mobile County, Alabama January 4, 1979. On March 31, 1986, another predecessor of Secor erroneously recorded a release of the mortgage in said probate court records. It is unchallenged that Haas has not satisfied the mortgage

indebtedness and that the mortgage was released in error. Subsequent to recording the release and after filing the Certificate of Subordination, the IRS filed notices of tax liens on the homestead of Haas totalling $506,523.24.

On October 7, 1991, Haas filed a petition for relief under Chapter 11 of the bankruptcy code and initiated an adversary proceeding in the bankruptcy court to determine, inter alia, the extent and validity of the competing liens on their homestead. The bankruptcy court, exercising its equitable powers, applied Alabama law and expunged the release from the probate records. As the IRS had not detrimentally relied upon the erroneous release when filing its tax liens, the bankruptcy court held that, under the definition of "security interest" contained in section 6323(h)(1) of the Internal Revenue Code, Secor's mortgage was "protected" during the times the IRS filed its tax liens. Thus, Secor's mortgage maintained priority over the federal tax liens. On appeal, the district court, adhering to the reasoning of the bankruptcy court, affirmed.

On appeal to the Eleventh Circuit, the court reversed, finding that, as to any federal tax liens filed **before** the IRS had knowledge that the release was in error, Alabama law would protect the IRS as a judgment creditor without notice. As to any federal tax liens filed **after** the IRS had notice of the erroneous release, the Court of Appeals held that the IRS would again prevail because, under Section 6323(h)(1), the IRS held the status of a "hypothetical judgment lien creditor" and under this aegis, issues of knowledge or notice were irrelevant, citing Dragstrem v. Obermeyer, 549 F.2d 20 (7th Cir. 1977). The Court of Appeals also found that Treasury Regulation §301.6323(h)-1(a)(2)'s prohibition against "relation back" precluded "equitable reinstatement" of the mortgage.

ARGUMENT

I. INTRODUCTION

This Petition asks the Court to consider whether Internal Revenue Code section 6323(h)(1) obviates the need for a case-by-case inquiry into whether the IRS had "notice" thereof. The Eleventh

Circuit embraced a "hypothetical judgment lien creditor test" over a "subjective knowledge lien creditor test," thereby deeming detrimental reliance, constructive notice or actual knowledge by the IRS, irrelevant. It is submitted that statutory construction and Congressional intent clearly require such an inquiry. The various circuit courts are in conflict as to which test, if any, is to apply. Also, Treas. Reg. §301.6323(h)(1) does not prohibit an erroneously released mortgage which is sufficiently "protected under local law" and perfected under this Court's recent test announced in U.S. by and through IRS v. McDermott, ___ U.S. _____, 113 S.Ct. 1926 (1993), from "relating back" to the date of its original recordation.

II. THE 1966 FEDERAL TAX LIEN ACT EXPRESSLY REQUIRES APPLICATION OF EQUITABLE PRINCIPLES

The principle statutory provisions governing the relationship of federal tax liens to the interests of other creditors are sections 6321-6323 of the Federal Tax

Lien Act of 1966[1] (the "Act"), codified at 26 U.S.C. §§6321-6323. With the Act, Congress intentionally modified prior federal tax law "to improve the status of private secured creditors and prevent impairment of commercial financing transactions by modernizing the relationship of federal tax liens to the interests of other creditors." U.S. v. Kimbell Foods, Inc., 440 U.S. 715, 738 (1979).

Federal law dictates the priority to be afforded a mortgage competing with a federal tax lien. Aquilino v. United States, 363 U.S. 509, 513-15 (1960); U.S. v. Rodgers, 461 U.S. 677, 683 (1983). The federal priority scheme is summarized succinctly as "first in time is first in right." McDermott, 113 S.Ct. at 1528;

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[1] H.R. Rep. No. 1884, 89th Cong., 2d Sess. 1 (1966).

U.S. v. New Britian, 344 U.S. 81, 85 (1954). Thus, Code section 6323(a), supra p. 2, provides that an unfiled federal tax lien is not valid against a prior security interest and, thus, any security interest in existence prior to the filing of notice of a federal tax lien takes priority over the tax lien. Section 6323(h)(1), supra p. 2, defines "security interest." This section states, inter alia, that an interest is in existence when it "has become protected under local law against a subsequent judgment lien." As stated by Congress and this Court, a mortgage is "protected" at the time notice of a federal tax lien is filed if the identity of the lienor, the property subject to the lien and the amount of the lien are all established at such time. House Report 1884; McDermott, 113 S.Ct. at 1528; New Britian, 347 U.S. at 84. "Where those

interests qualify under the definitions they are to be accorded... priority status whether or not they are in all other respects definite and complete at the time notice of the [federal] tax lien is filed."[2] Thus, an interest need not be perfected under the relevant local law, rather, merely "protected" against a subsequent judgment lien. Dragstrem v. Obermeyer, 549 F.2d 20, 24-25 (7th Cir. 1977).

A federally cognizable security interest is in part dependent upon state law. In the instant case, Alabama law is the relevant "local law" which determines whether a mortgage improvidently released is protected against a "subsequent judgment lien." The well settled rule in Alabama is articulated in Gordon v.

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[2] H.R. Rep. No. 1884.

Gorman, 436 So.2d 851, 855 (Ala. 1983), and Taylor v. Jones, 194 So.2d 80, 84 (Ala. 1967), to-wit: a mortgage erroneously satisfied of record may be expunged from the probate records when such relief will not prejudice the rights of innocent or third parties.[3] Under this general rule, the individual protected is "one who has innocently relied on the release and either purchased the property or made a loan thereon on the strength of such cancellation." U.S. v. 168.8 Acres

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[3] This is the rule in an overwhelming number of states. For citations to states which follow the general rule, see 59 C.J.S. Mortgages §282(2) ns. 18-21. See also Connecticut Nat. Bank v. Chapman, 216 A.2d 814 (Conn. 1966); Republic Nat. Bank of Miami v. Manzini & Associates P.A., 612 So.2d 709 (Fla. App. 3 Dist. 1993); Strong v. Powell, 192 So.2d 258 (Miss. 1966); Cameron State Bank v. Sloan, 559 S.W.2d 564 (Mo. App. 1977); Allied Group Mortg. Corp. v. Dewing, 498 N.W.2d 196 (N.D. App. 1993); In re Veasey, 43 B.R. 396 (Bankr. Pa. 1984). Cf. Citizens State Bank v. U.S., 932 F.2d 490 (6th Cir.1991) (Kentucky).

of Land, Etc., 35 F. Supp. 724, 726 (M.D.N.C. 1940). This rule estops a creditor from taking advantage of a mortgage satisfied in error unless the creditor relied on the satisfaction of the mortgage. Gordon, 436 So.2d at 855.[4] In order for a subsequent judgment lien to prime a prior lien erroneously released, the subsequent lienor must have acted to its prejudice by relying upon the apparent release of the senior lien. It follows that a judgment lien is typically not protected because such a lienor

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[4] An identical inquiry is required when a mortgagee releases a first mortgage for a second mortgage and the mortgagee does not immediately record the second mortgage and a competing lien is filed during the intervening time period. The rule is that an intervening lienor does not thereby achieve priority over the first lien unless the intervening lien is prejudiced by relying upon the apparent discharge. Carco Acceptance Corp. v. Kunze, 69-2 USTC 85,636 (D. Neb. 1969). See, e.g., 56 C.J.S. Mortgages § 282(2).

customarily does not in any manner rely on the existence or nonexistence of a mortgage when filing its judgment.[5]

However, the Court of Appeals declined "to adopt an equitable overlay to the statutory framework" and instead sought to rely upon the Alabama Recording Statute, §35-4-90(a) (supra, p. 3), which protects a "judgment creditor without notice" of an earlier, unrecorded mortgage (Appendix A, pp. 17-19). This was reversible error because the Alabama Recording Statute was promulgated prior to the decisions in Gordon and Taylor.[6] It is a basic concept of statutory construction that when a federal court

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[5] In the instant case, the IRS did not rely upon the release when filing its tax liens (Appendix A, pp. 4 & 41).

[6] The Alabama Recording Statute has remained unchanged since 1907. Section 3383, Chapter 68, Code of 1907.

interprets a state statute, the federal court must follow the interpretation of such statutes by courts of the enacting state. U.S. v. Thirty-Seven Photographs, 402 U.S. 363 (1971); Bank of Heflin v. Miles, 621 F.2d 108, 113-114 (11th Cir. 1980). This Court has stated that "when application of a federal statute depends on an issue of state law, a federal court should defer to the ruling of the highest court of the state on that issue." Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967). Hence, the inquiry is not notice per the Alabama Recording Statute, but reliance per the subsequent interpretive case law. Gordon and Taylor are the latest expressions by the Alabama Supreme Court concerning erroneously released mortgages and their holdings govern and control the nature of mortgages in terms of the federal concept of

"protected under local law."

The Court of Appeals further stated that it "would be forced to reject such a purely equitable inquiry as contrary to the overriding federal scheme of priorities" (Appendix A, p.18, n. 8). Rather than defer to the Alabama Supreme Court on the subject, the Eleventh Circuit dismissed reliance as "meaningless when applied to the IRS" (Appendix A, p. 26). Rejection of such an inquiry is contrary to Congressional intent for it is the plain language of the Act which imparts non-uniformity into the resolution of priority disputes by requiring the application of "local law" via §6323 (h)(1). Because local law mandates an "equitable inquiry," then the adjudicating federal court is seemingly compelled under the Act to perform such an analysis, even if one state would protect an erroneously

released mortgage against subsequent judgment lienors, while another state, would not.[7]

In BFP v. Resolution Trust Corp., ___ U.S. ___, 114 S. Ct. 1757 (1994), this Court observed that "federal statutes impinging upon important state interests cannot...be construed without regard to the implications of our dual system of government." 114 S. Ct. at 1764. This Court continued:

> It is beyond question that an essential state interest is at issue here; we have said that "the general welfare of society is involved in the security of the titles to real estate" and the power to ensure that

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[7] Compare Gordon and Taylor, supra, with Citizens State Bank v. U.S., 932 F.2d 490 (6th Cir. 1991) (Kentucky). Real property security law is in many cases not uniform, but unique on a state-by-state basis. Realty cannot be placed into interstate commerce, and the public policy argument for uniformity is much less compelling if not absent altogether with respect thereto.

> security "inheres in the very nature of [state] government."

Id. at 1764-1765. In declining to place a "federally created cloud" upon the title to realty purchased at foreclosure, this Court stated that "to displace traditional state regulation in such a manner, the federal statutory purpose must be clear and manifest." Id. at 1765. Unless Congressional intent is "clear and manifest" to depart from "local law," the federal courts must defer to a state's reliance standard.

Moreover, the Court of Appeals erred in failing to recognize that, under the Alabama Recording Statute, "notice" pertains to notice of the existence of a real property interest in the first place, not notice or knowledge that a release occurred or that such a release was erroneous. The Alabama Recording Statute

protects a judgment lienor against an unrecorded mortgage only when the judgment lienor "records its instrument without actual knowledge or constructive notice of the earlier conveyance."[8]

In the instant case, the "notice" attributable to the IRS is notice of the 1979 Secor mortgage from the outset, not notice or knowledge that the mortgage release occurred in error.[9] Even though

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[8] Baldwin County Fed. Sav. v. Central Bank, 585 So.2d 1279, 1281 (Ala. 1991). See also, Smith v. Arrow Transp. Co., Inc., 571 So.2d 1003, 1006 (Ala. 1990); Department of Revenue v. Price-Williams, 545 So.2d 7, 9 (Ala. 1989).

[9] From the day Secor's mortgage was created and at all times thereafter, the IRS knew of Secor's mortgage, as on January 4, 1979, the day Secor's mortgage originated, $94,942.21 was paid out of the mortgage loan proceeds to the IRS to satisfy the then existing federal tax obligation of the Haas', whereupon the IRS executed a Certificate of Subordination of Tax Lien, which by its terms expressly acknowledges the priority of the Secor mortgage.

Secor's mortgage was erroneously released, and, therefore, arguably unrecorded, the IRS's actual knowledge that Secor held a mortgage is fatal to the IRS's priority claim.

III. THE STATUS OF "ANY HYPOTHETICAL JUDGMENT LIEN CREDITOR" ACCORDS THE IRS SUPERIOR STATUS RELATIVE TO OTHER CREDITORS CONTRARY TO THE ACT AND CONGRESSIONAL INTENT

In reconciling priority between Secor's mortgage and those IRS tax liens filed after the IRS had notice or knowledge that the release occurred in error, the Court of Appeals adopted the Government's position that Section 6323(h)(1)'s language, "a subsequent judgment lien," is synonymous with "any hypothetical judgment lien creditor," and, therefore, the IRS is equivalent to "any hypothetical judgment lien creditor" and a lack of notice or knowledge of the prior competing mortgage is imputed thereto.

"Protected under local law against a subsequent judgment lien" seemingly compels interpretation of what Congress meant by the term "judgment lien." Neither Congress nor the Act defines the term. The circuits have taken diametric approaches interpreting the term "judgment lien." A definitive declaration by this Court would, then, be most welcome.

One line of cases applies the "subjective knowledge lien creditor" ("lien creditor") test and views the government as a lien creditor. Under this view, if the government obtains actual or constructive knowledge of the competing interest prior to filing its federal tax liens, and if, under local law a judgment lien creditor is protected only if it is without either notice or knowledge of the prior interest, the federal tax lien is not entitled to priority over the

interest. See, U.S. v. Ed Lusk Constr. Co., Inc., 504 F.2d 328, 331 (10th Cir. 1974); Manalis Finance Co. v. U.S., 611 F.2d 1270, 1273-74 (9th Cir. 1980); Metropolitan Nat. Bank v. U.S., 901 F.2d 1297, 1301, n.1 (5th Cir. 1990); U.S. v. Trigg, 465 F.2d 1264, 1268-69 (8th Cir. 1972), cert. denied, 410 U.S. 909 (1973).

Conversely, the "hypothetical judgment lien creditor test" focuses on whether the security interest is protected under local law against "any hypothetical judgment lien creditor" that might arise, regardless whether or not the government has knowledge of the competing nonfederal interest. Dragstrem, 549 F.2d at 25-27; In re Haas, Appendix A.

Secor submits that the "subjective lien creditor test" is the more reasoned "test" because it treats the IRS like every other creditor and insures that it

not be given preferential treatment. Holding the IRS accountable for knowledge it possesses simply places it on a field level with other creditors. As noted by this Court in Kimbell Foods, "the Federal Tax Lien Act...provides further evidence that treating the United States like any other lender would not undermine federal interests." Kimbell Foods, 440 U.S. at 738. The principles of the Act would not be frustrated, for the vast majority of instances where the IRS files its liens occurs "without notice," as it typically does not review the probate court indices prior to filing a tax lien. Therefore, the IRS would ordinarily be protected "under local law" against a prior unperfected lien of which it was unaware.

Bestowing upon the IRS status of "any hypothetical judgment lien creditor" is contrary to the process of protection in

the federal sense, that is, per the terms of Section 6323(h)(1) ("under local law"). The creation of enhanced priority for the IRS by ignoring notice or knowledge is an act of legislative modification, not statutory interpretation. The phrase "under local law" belies any assertion that Congress intended a uniform standard across the nation. This Court noted in Kimbell Foods that the IRS is to enjoy no privileged status under the Act. However, the status now given the IRS by the Court of Appeals allows the IRS to unjustly enrich itself while any other creditor similarly situated would be subject to either its knowledge, notice or lack of reliance and would not be allowed to gain such an unconscionable advantage as the IRS has achieved. The unsound basis of the "hypothetical judgment lien creditor test" was exposed and rejected by the

Ninth Circuit in Manalis, where the court stated:

> the government's interpretation of §6323(h)(1) is contrary to Congress' intent, expressed in the [Act], to improve the position of the private secured creditor in the face of a federal tax lien on the secured property. If §6323(h)(1) requires the security interest to be protected against "any hypothetical judgment lien creditor," then no security interest perfected under the U.C.C. would qualify."

Manalis, 611 F.2d at 1274.

If reliance, actual knowledge and constructive notice are all "meaningless" when applied to the IRS, as the Eleventh Circuit held below (Appendix A, p. 26), then the very purpose of the Act is in effect destroyed. There will always be some foreseeable situation whereby an otherwise superior mortgagee would be primed by subsequently filed federal tax liens under this concept. Simply put,

applying the "hypothetical judgment lien creditor" test contravenes both Congressional intent and the express language of the Act. The principle of "first in time, first in right," upon which the Act is based, is utterly frustrated thereunder. In short, the IRS would prevail over **any** competing lien, **regardless** of the respective dates of recordation and the like.

IV. THE RELATION BACK PROHIBITION PERTAINS ONLY TO THE "PROCESS" OF PERFECTION.

The Court of Appeals committed error in Section B of In re Haas when it held that Treas. Reg. §301.6323(h)-1(a)(2) (Appendix C) prohibited the "relation back" of a reinstated mortgage to the original date of recording (Appendix A, p. 38). This regulation has been interpreted by one circuit as pertaining to the process of perfection. In Manalis, the

Ninth Circuit stated that "[t]he phrase 'actions required under local law to establish the priority of a security interest' generally describes the process of perfection." Manalis, 611 F.2d at 1274.

The Eleventh Circuit's statement that "[t]he final action required under local law would be the reinstatement of the mortgage" is misguided (Appendix A, p. 40). Secor's mortgage was perfected January 4, 1979. Reinstatement nullified an unintended clerical blunder to prevent a future creditor from relying thereupon.

Foremost, under Code section 6323(h)(1), the security interest need not be "perfected," rather merely "protected". Dragstrem, 549 F.2d at 24-25. Under Alabama Law, a mortgage cancelled in error is not necessarily effective in rendering

the subject mortgage unsecured.[10] An unrecorded mortgage is "good" between the mortgagee and mortgagor. Arrow Transp., 571 So.2d at 1006; White v. White, 350 So.2d 326 (Ala. 1977). An unrecorded mortgage is also "protected" against a judgment creditor with notice of the existence of such mortgage. §35-4-90(a), supra, p.3; Arrow Transp., 571 So.2d at 1006. Moreover, this Court's precedent deems a mortgage to be choate and "perfected" for priority purposes when "the identity of the lienor, the property subject to the lien and the amount of the

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[10] Recording a release in satisfaction of a debt secured by a mortgage is not conclusive evidence of the actual payment of the mortgage. Bay Minette Production Credit Association v. Citizens' Bank, 551 So. 2d 1046, 1048 (Ala. 1989). Rather, "the intent of the mortgagee and mortgagor in executing the instrument declaring the debt satisfied, together with the surrounding circumstances," is controlling. Id.

lien are established." McDermott, 113 S.Ct. at 1528-29; New Britian, 347 U.S. at 84. In the instant case, Secor's mortgage satisfied this Court's standards for "choatness" and "perfection."

V. CONCLUSION

Congressional intent and the express language of Section 6323(h)(1) is contrary to the decision below which ignores the IRS's actual knowledge of Secor's mortgage and the IRS' lack of reliance upon the release of said mortgage. Such an interpretation frustrates the core purpose of the 1966 Federal Tax Lien Act: to place the IRS on a playing field level with private creditors and prevent it from gaining an unconscionable advantage over private creditors.

The Secor mortgage was sufficiently "choate" and protected at the time the IRS liens were filed without the need to

"relate back" to any date prior to its original recordation in 1979. Consequently, Treas. Reg. §301.6323(h)-1(a)(2) does not apply so as to proscribe reinstatement thereof.

For the reasons stated, the Petition for Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit should be granted.

Respectfully submitted,

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